

HB

503

Alaska State Legislature
House Finance Committee

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MEMORANDUM

TO: Senator Ralph Seekins, Chair
Senate Judiciary Committee

FROM: Representative John Harris, Co-Chair
House Finance Committee

DATE: April 5, 2004

RE: Request for Scheduling

Please consider this request to schedule House Bill 503: An Act relating to the tobacco product Master Settlement Agreement; and providing for an effective date, at your earliest possible convenience.

The bill requires non-participating manufacturers to make a deposit into escrow that is roughly the same as what they would pay under the Master Settlement Agreement. So if the MSA would require tobacco manufacturers to pay 2 cents per cigarette, under this statute they have to deposit into escrow 2 cents per cigarette—and leave it there. In sum, it ensures that all tobacco manufacturers selling cigarettes in Alaska will pay approximately 2 cents per cigarette, either into an escrow account or into the MSA revenue fund.

I appreciate your consideration of my request. Please do not hesitate to contact either Tom Wright of my staff or me if we can provide further information or answer any questions you may have in regards to this legislation.

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SPONSOR STATEMENT

HOUSE BILL 503: *An Act relating to the tobacco product Master Settlement Agreement; and providing for an effective date.*

HB 503 is a bill related to the tobacco Master Settlement Agreement. Under the Master Settlement Agreement, we enacted AS 45.53 in 1999 so as to level the economic playing field between those tobacco manufacturers that participated in the MSA and those that didn't. AS 45.53 requires all non-participating manufacturers to deposit a certain amount of money into an escrow account—this year about two cents per cigarette—in order to level the playing field.

AS 45.53 lets non-participating manufacturers withdraw money from the escrow account if the amount they put in is more than what the state would have received had the non-participating manufacturer ("NPM") been a participant in the MSA. While this sounds fair, in actual practice it is not. It allows NPMs to concentrate their markets in certain states and receive a substantial windfall by withdrawing from the escrow account far more than was originally intended.

This bill was drafted by the National Association of Attorneys General and was unanimously supported by its membership. Simply put, it requires NPMs to make a deposit into escrow that is roughly the same as what they would pay under the MSA. So if the MSA would require tobacco manufacturers to pay 2 cents per cigarette, under this statute they have to deposit into escrow 2 cents per cigarette—and leave it there. In sum, it ensures that all tobacco manufacturers selling cigarettes in Alaska will pay approximately 2 cents per cigarette, either into an escrow account or into the MSA revenue fund.

This bill has two contingent sections, if for some reason a court objects to this provision. If section 1 is found unconstitutional, then section 2 comes into effect which would prohibit any withdrawal by an NPM from an escrow account until the money has been in escrow for 25 years. If section 2 is found unconstitutional, then the current language now in effect is revived in section 3.

FISCAL NOTE

STATE OF ALASKA
2004 LEGISLATIVE SESSION

Fiscal Note Number: 1
 Bill Version: HB 503
 (H) Publish Date: 2/26/04

Revision Date/Time (Note if correction): _____ Dept. Affected: Revenue
 Title Tobacco Master Settlement Agreement RDU Revenue Programs & Services
 Component Tax Division
 Sponsor House Finance
 Requester House Finance Component No. 2476

Expenditures/Revenues (Thousands of Dollars)

Note: Amounts do not include inflation unless otherwise noted below.

OPERATING EXPENDITURES	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010
Personal Services						
Travel						
Contractual						
Supplies						
Equipment						
Land & Structures						
Grants & Claims						
Miscellaneous						
TOTAL OPERATING	0.0	0.0	0.0	0.0	0.0	0.0

CAPITAL EXPENDITURES						
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CHANGE IN REVENUES ()						
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FUND SOURCE (Thousands of Dollars)

FUND SOURCE	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010
1002 Federal Receipts						
1003 GF Match						
1004 GF						
1005 GF/Program Receipts						
1037 GF/Mental Health						
Other (Specify Type--Do not abbreviate)						
TOTAL	0.0	0.0	0.0	0.0	0.0	0.0

Estimate of any current year (FY2004) cost: 0.0

Check this box (X) if funding for this bill is included in the Governor's FY 2005 budget proposal:

POSITIONS

Full-time	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010
Part-time						
Temporary						

ANALYSIS: (Attach a separate page if necessary)

Tobacco Master Settlement Agreement - Bill Analysis

This bill, based on a model developed by the National Association of Attorneys General in cooperation with a working group of participating states, is designed to preserve, to the fullest extent possible, the revenue stream under the tobacco product Master Settlement Agreement (MSA) and AS 45.53. One of the provisions of the MSA required states to enact legislation that would "level the playing field" for non-participating tobacco manufacturers by requiring them to deposit money into escrow for every cigarette they sell in the state. Nonparticipating manufacturers have discovered a "loophole" that allows them to remove escrow payments from individual state escrow accounts which has given them a competitive advantage over those manufacturers that signed the MSA. This bill is intended to close the "loophole" and ensure a "level playing field" as originally intended by AS 45.53

Prepared by: Johanna Bales Phone 269-6628
 Division Tax Division Date/Time 2/24/04 4:39 PM
 Approved by: Steve Porter, Deputy Commissioner Date 2/24/2004
 Agency Department of Revenue

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SECTIONAL ANALYSIS

HOUSE BILL 503: *An Act relating to the tobacco product Master Settlement Agreement; and providing for an effective date.*

Section 1: Amends AS 45.53.020(b)(2), Requirements. Language clarifies that a non-participating tobacco manufacturer in the Master Settlement Agreement must deposit money into escrow for every cigarette they sell in the state. Removes a loophole that allowed NPMs to remove escrow payments from individual state accounts. Currently, an NPM is supposed to deposit only a percentage of its cigarette sales into escrow.

Section 2: Repeals and reenacts AS 45.53.020(b), Requirements. Provisional language if a court finds section 1 of this legislation unconstitutional. States that funds placed into escrow may only be released to pay a judgment or settlement on a released claim or after 25 years after the date on which funds were placed into escrow.

Section 3: Repeals and reenacts AS 45.53.020(b), Requirements. Provisional language if a court finds section 1 and/or section 2 of this legislation unconstitutional. Reverts to original language found in current statute, AS 45.53.020(b).

Section 4: Conditional effective date. Section 2 takes effect only if section 1 of this bill is found to be unconstitutional. If section 2 is found to be unconstitutional, then section 3 takes effect.

Section 5: Section 1 effective date of July 1, 2004.

Section 6: Section 2 takes effect on the day after the date of a final order or decision by a court if section 1 is found to be unconstitutional.

Section 7: Section 3 takes effect on the day after the date of a final order or decision by a court if section 2 is found to be unconstitutional.

THE
FOLLOWING
DOCUMENT(S)
ARE
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Chapter 45.53. CIGARETTE SALES

Sec. 45.53.010. Tobacco product Master Settlement Agreement recognized.

The Master Settlement Agreement entered into by certain United States tobacco product manufacturers and the state, and related documents, for settlement of claims raised in State of Alaska v. Philip Morris, Incorporated, and approved by the Alaska Superior Court on February 9, 1999, are recognized.

Sec. 45.53.020. Requirements.

(a) Any tobacco product manufacturer selling cigarettes to consumers within the state, whether directly or through a distributor, retailer, or similar intermediary or intermediaries, after June 4, 1999, shall do one of the following:

(1) become a participating manufacturer, as that term is defined in sec. II(jj) of the Master Settlement Agreement, and generally perform its financial obligations under the Master Settlement Agreement; or

(2) place into a qualified escrow fund by April 15 of the year following each listed calendar year the following amounts, as such amounts are adjusted for inflation:

(A) for 1999, \$.0094241 per unit sold on or after June 4, 1999, but before January 1, 2000;

(B) for 2000, \$.0104712 per unit sold during that year;

(C) for each of 2001 and 2002, \$.0136125 per unit sold during the year in question;

(D) for each of 2003 through 2006, \$.0167539 per unit sold during the year in question;

(E) for each of 2007 and each year thereafter, \$.0188482 per unit sold during the year in question.

(b) A tobacco product manufacturer that places money into escrow under (a)(2) of this section is entitled to receive the interest or other appreciation on such money as earned. Such money itself shall be released from escrow only under the following circumstances:

(1) to pay a judgment or settlement on a released claim brought against such tobacco product manufacturer by this state or a releasing party located or residing in this state; the funds shall be released from escrow under this paragraph in the order in which they were placed into escrow and

only to the extent and at the time necessary to make payments required under the judgment or settlement;

(2) to the extent that the tobacco product manufacturer establishes that the amount that it was required to place into escrow in a particular year was greater than the state's allocable share of the total payments that the manufacturer would have been required to make in that year under the Master Settlement Agreement had it been a participating manufacturer, as such payments are determined under sec. IX(i)(2) of the Master Settlement Agreement and before any of the adjustments or offsets described in sec. IX(i)(3) of that agreement other than the inflation adjustment, the excess shall be released from escrow and revert back to that tobacco product manufacturer; or

(3) to the extent not released from escrow under (1) or (2) of this subsections, funds placed into escrow shall be released from escrow and revert back to the tobacco product manufacturer 25 years after the date on which they were placed into escrow.

(c) To be a qualified escrow fund under this section, the

(1) fund must be an escrow fund governed by an escrow arrangement with a federally or state chartered financial institution having no affiliation with a tobacco product manufacturer and having assets of at least \$1,000,000,000; and

(2) escrow arrangements described in (1) of this subsection must

(A) require that the financial institution hold the principal of the escrow fund for the benefit of releasing parties; and

(B) prohibit the tobacco product manufacturer that places money into the escrow fund from using, accessing, or directing the use of the principal of the fund except as consistent with this section.

Sec. 45.53.030. Regulations.

The commissioner of revenue shall adopt regulations under AS 44.62 (Administrative Procedure Act) necessary to ascertain the amount of excise tax paid on the cigarettes of a tobacco product manufacturer for each year for which the manufacturer is required to place money into a qualified escrow fund under AS 45.53.020 .

Sec. 45.53.040. Certification of compliance; civil actions.

(a) A tobacco product manufacturer that elects to comply with AS 45.53.020 by placing money into escrow under that section shall annually, at

the time of compliance, certify to the commissioner of revenue that it is in compliance with AS 45.53.020 .

(b) If the commissioner of revenue does not timely receive a certification of compliance from a tobacco product manufacturer as required by (a) of this section, the commissioner shall notify the attorney general. The attorney general shall require the manufacturer, within 15 days, to place into a qualified escrow fund the money necessary to bring the manufacturer into compliance with AS 45.53.020 . The attorney general may bring a civil action on behalf of the state against a tobacco product manufacturer that fails to place into a qualified escrow fund the money necessary to bring the manufacturer into compliance with AS 45.53.020 . The court, upon a finding of a tobacco product manufacturer's

(1) violation of AS 45.53.020 , shall require the manufacturer, within 15 days, to place into a qualified escrow fund the money necessary to bring the manufacturer into compliance with AS 45.53.020 and may impose a civil penalty, in an amount not to exceed five percent of the amount improperly withheld from escrow, for each day of the violation; the total amount of the penalty under this paragraph may not exceed 100 percent of the original amount improperly withheld from escrow;

(2) knowing violation of AS 45.53.020 , shall require the manufacturer, within 15 days, to place into a qualified escrow fund the money necessary to bring the manufacturer into compliance with AS 45.53.020 and may impose a civil penalty, in an amount not to exceed 15 percent of the amount improperly withheld from escrow, for each day of the violation; the total amount of the penalty under this paragraph may not exceed 300 percent of the original amount improperly withheld from escrow; and

(3) second knowing violation of AS 45.53.020 , shall require the manufacturer, within 15 days, to place into a qualified escrow fund the money necessary to bring the manufacturer into compliance with AS 45.53.020, and may impose a monetary penalty as described in (2) of this subsection, and shall prohibit the manufacturer from selling cigarettes to consumers within the state, whether directly or through a distributor, retailer, or similar intermediary, for a period not to exceed two years.

(c) In addition to the civil penalties described in (b) of this section, the court may award the state full reasonable attorney fees and costs if the state prevails in a civil action brought under (b) of this section.

(d) Each failure to make an annual placement of money into a qualified escrow fund as required by AS 45.53.020 is a separate violation for the purposes of this section.

Sec. 45.53.100. Definitions.

In this chapter,

(1) "adjusted for inflation" means increased in accordance with the formula for inflation adjustment set out in Exhibit C to the Master Settlement Agreement;

(2) "affiliate" means a person who directly or indirectly owns or controls, is owned or controlled by, or is under common ownership or control with, another person; in this paragraph,

(A) "owns," "is owned," and "ownership" mean ownership of an equity interest, or the equivalent thereof, of 10 percent or more;

(B) "person" means an individual, a partnership, a committee, an association, a corporation, or any other organization or group of persons;

(3) "allocable share" means allocable share as that term is defined in the Master Settlement Agreement;

(4) "cigarette"

(A) means any product that contains nicotine, is intended to be burned or heated under ordinary conditions of use, and consists of or contains

(i) any roll of tobacco wrapped in paper or in any substance not containing tobacco;

(ii) tobacco, in any form, that is functional in the product, which, because of its appearance, the type of tobacco used in the filler, or its packaging and labeling is likely to be offered to, or purchased by, consumers as a cigarette; or

(iii) any roll of tobacco wrapped in any substance containing tobacco which, because of its appearance, the type of tobacco used in the filler, or its packaging and labeling, is likely to be offered to, or purchased by, consumers as a cigarette described in (i) of this subparagraph;

(B) includes "roll-your-own"; for purposes of this subparagraph,

(i) 0.09 ounces of "roll-your-own" tobacco constitutes one individual "cigarette;"

(ii) "roll-your-own" includes any tobacco that, because of its appearance, type, packaging, or labeling is suitable for use and likely to be offered to, or purchased by, consumers as tobacco for making cigarettes;

(5) "Master Settlement Agreement" means the settlement agreement and related documents described in AS 45.53.010 ;

(6) "original participating manufacturer" means "original participating manufacturer" as that term is defined in the Master Settlement Agreement;

(7) "qualified escrow fund" means a fund described in AS 45.53.020(c);

(8) "released claims" means "released claims" as that term is defined in the Master Settlement Agreement;

(9) "releasing parties" means "releasing parties" as that term is defined in the Master Settlement Agreement;

(10) "tobacco product manufacturer"

(A) means an entity that, on or after June 4, 1999, directly, and not exclusively through an affiliate,

(i) manufactures cigarettes anywhere that such manufacturer intends to be sold in the United States, including cigarettes intended to be sold in the United States through an importer; provided, however, that an entity that manufactures cigarettes that it intends to be sold in the United States shall not be considered to be a tobacco product manufacturer under this clause (i) if, first, such cigarettes are sold in the United States exclusively through an importer that is an original participating manufacturer, as that term is defined in the Master Settlement Agreement, that will be responsible for the payments under the Master Settlement Agreement with respect to such cigarettes as a result of the provisions of sec. II(mm) of the Master Settlement Agreement and that pays the taxes specified in sec. II(z) of the Master Settlement Agreement, and, second, the manufacturer of such cigarettes does not market or advertise such cigarettes in the United States;

(ii) is the first purchaser anywhere for resale in the United States of cigarettes manufactured anywhere that the manufacturer does not intend to be sold in the United States; or

(iii) becomes a successor of an entity described in (i) or (ii) of this subparagraph;

(B) does not include an affiliate of an entity described in (A) of this paragraph unless the affiliate itself meets the standards set out in any of (A)(i) - (iii) of this paragraph;

(11) "units sold" means the number of individual cigarettes sold in the state by the applicable tobacco product manufacturer, whether directly or

through a distributor, retailer, or similar intermediary or intermediaries, during the year in question, as measured by excise taxes collected by the state on packs or "roll-your-own" tobacco containers.

RESOLUTION SUPPORTING ALLOCABLE SHARE LEGISLATION

WHEREAS, Cigarette smoking presents serious public health concerns to the States, requires the States to spend billions of dollars for the treatment of health conditions resulting from Cigarette smoking, and imposes substantial additional costs on the States, many of which costs occur years after the Cigarettes are sold; and

WHEREAS, 46 States, the District of Columbia, the Commonwealth of Puerto Rico, and four United States territories ("the Settling States") and more than 40 Cigarette manufacturers are parties to the tobacco Master Settlement Agreement of 1998 ("the MSA") under which Cigarette manufacturers who are parties to the MSA have agreed to significant limitations on the advertising, promotion, and marketing of Cigarettes and agreed to make substantial payments to the States in exchange for a release from liability for certain claims of the States related to Cigarette smoking; and

WHEREAS, in connection with the MSA the Settling States have enacted statutes that require Cigarette manufacturers who do not become parties to the MSA ("Non-Participating Manufacturers" or "NPMs") to make payments into an escrow fund of a specified amount for each of its Cigarettes sold in the State; and

WHEREAS, the Escrow Statute is designed to ensure that a Settling State that obtains a judgment against an NPM for the costs imposed by sales of the NPM's Cigarettes will have an Escrow Fund available against which to satisfy a judgment; and

WHEREAS, in the absence of a significant escrow fund, companies that choose not to enter into the MSA and are not subject to its restrictions on advertising and promotion would be able to sell cigarettes without making any provision for the costs imposed on the State by the sales of their cigarettes; and

WHEREAS, the existing escrow statutes as originally enacted by the Settling States contain language that inadvertently permits NPMs that concentrate their sales in only a few states to avoid the large majority of their obligation to keep funds in escrow and thereby confers on those companies an unfair competitive advantage over both Participating Manufacturers and over other NPMs; and

WHEREAS, as a result of this language several NPMs have enjoyed an unintended competitive advantage over the more than 40 companies that have chosen to join the Master Settlement Agreement and have thereby expanded their sales at the expense of those companies; and

WHEREAS, permitting NPMs to make sales in any State without requiring them to keep significant escrow funds on deposit jeopardizes the health care objectives and MSA payments of all States; and

WHEREAS, the availability of low-priced cigarettes made possible by the

deficiencies in the existing escrow statutes has reduced the effectiveness of State programs to discourage youth smoking; and

WHEREAS, a large number of States, recognizing the deficiency in the existing escrow statutes, jointly developed proposed legislation (the "Allocable Share legislation," attached as Tab A hereto) designed to eliminate this inadvertent deficiency and to serve the purposes for which the escrow statute was originally designed; and

WHEREAS, the Tobacco Committee of the National Association of Attorneys General considered and endorsed enactment of the Allocable Share legislation; and

WHEREAS, seventeen States have already enacted the Allocable Share legislation and the legislation is under consideration in other jurisdictions;

NOW, THEREFORE, be it resolved that the National Association of Attorneys General:

1. Reaffirms the principle that the purpose of the escrow statute is to preserve the public health gains of the MSA by ensuring that all Cigarette manufacturers selling Cigarettes in a State must either join the MSA, restrict their advertising and promotion, and make MSA payments to compensate the State for the costs imposed on the State by cigarette smoking or establish and maintain an escrow fund sufficient to ensure that significant funds will be available in the event that the State obtains a judgment for such costs; and
2. Recognizes that the existing escrow statutes as originally drafted and enacted do not always accomplish this objective; and
3. Endorses the enactment of the Allocable Share Amendment in each Settling State in order that this objective be accomplished; and
4. Directs the Executive Director to communicate this resolution to interested parties; and
5. Directs the Tobacco Project to provide support to attorneys general for the enactment of the legislation.

NATIONAL ASSOCIATION OF ATTORNEYS GENERAL

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**CHANGES TO THE ALLOCABLE SHARE PROVISION
OF THE MODEL ESCROW STATUTE****INTRODUCTION AND ANALYSIS*****WHY IS THIS LEGISLATION IMPORTANT?***

Enactment of the proposed change to the Model Act is necessary to avoid hundreds of millions of dollars in losses to the States' tobacco payments under the MSA. The proposed change is also important to ensure that the central public health purposes of the MSA are met. The Model Escrow Statute was enacted to ensure that Settling States would receive the benefits of the MSA and that companies that refused to enter into the MSA would not thereby be able to profit unfairly from such refusal. Some companies that neither make MSA payments to the States nor observe any of the public health restrictions in the MSA are profiting from a loophole in the current law that allows them to avoid any significant responsibility under the State's Model Escrow Statute. This amendment is designed to ensure that the Model Escrow Statutes operate evenhandedly as originally intended, thereby advancing the legitimate health and safety goals contemplated by the MSA.

WHAT IS THE MSA AND WHAT DOES IT PROVIDE?

The MSA was executed on November 23, 1998 by 52 Settling States with the major tobacco companies and numerous smaller manufacturers (collectively known as "Participating Manufacturers" or "PMs"). The MSA provides that in exchange for the agreement of the PMs to make specified payments to the Settling States -- estimated to exceed \$200 billion through 2025 -- and their agreement to abide by extensive public health restrictions on the advertising, promotion and marketing of cigarettes, the Settling States agreed to release the PMs from claims by the States. Tobacco Product Manufacturers that did not sign the MSA ("Non-Participating Manufacturers" or "NPMs") were not released from potential State claims and did not undertake any of the payment obligations or agree to abide by the public health restrictions.

The parties to the MSA also proposed a "Model Statute" designed to prevent NPMs from taking advantage of the fact that they do not make payments under the MSA and are not bound by the public health, advertising and other MSA restrictions. The Model Statute requires all NPMs whose cigarettes are sold in a State to establish and annually fund a qualified escrow account in an amount determined by the sales volume in the State. Funds deposited in the escrow account are released to the NPM after 25 years if not used before then to pay a judgment in favor of the State against the NPM. All Settling States enacted a Model Escrow Statute.

WHAT ARE THE PURPOSES OF THE MODEL ESCROW STATUTE?

In the MSA the States released their claims against companies that joined the MSA and that thereby agreed to make MSA payments and abide by the public health provisions of the MSA. As noted, companies that chose not to join the MSA were not released from claims by the States. They do not make MSA payments and they are not required to abide by the public health provisions of the MSA.

There was a concern, however, that NPMs could sell cigarettes in the States, take advantage of the fact that they did not have to bear the cost of making MSA payments or abide by the public health provisions of the MSA, yet be unable to satisfy judgments that the States might eventually obtain for the costs imposed as a result of these sales. The Model Escrow Statute is designed to ensure that there will be a fund available to satisfy State claims in the event the State obtains a judgment against an NPM. In addition, under the MSA, Settling States that enact and "diligently enforce" a Model Escrow Statute are not subject to certain potential downward adjustments to their MSA payments.

HOW DOES THE MODEL ESCROW STATUTE WORK?

The Model Escrow Statute requires an NPM to make escrow deposits on its cigarettes sold in a Settling State at a set figure per cigarette sold (about 1.5¢ 2002 sales). Deposits remain the property of the NPM and the NPM earns currently-payable interest. Principal must remain in escrow for twenty-five years to be available to meet potential State claims. In order to fairly estimate the sum necessary to satisfy any potential judgment a State may obtain, the NPM escrow obligation is calculated to approximate the MSA payment on a per-cigarette basis (and does so almost precisely).

HOW HAVE THE PURPOSES OF THE MODEL ESCROW STATUTE BEEN SUBVERTED BY THE CURRENT ALLOCABLE SHARE RELEASE PROVISION?

A provision of the Model Escrow Statute permits an NPM to obtain a release of funds from escrow "to the extent that a tobacco product manufacturer establishes that the amount it was required to place into escrow in a particular year was greater than the State's allocable share of the total payments that such manufacturer would have been required to make in that year under the Master Settlement Agreement ... had it been a Participating Manufacturer under the MSA...." Experience in several states has shown that this provision enables NPMs that concentrate their sales in a single state or a few states to obtain early releases of the great majority of their escrow deposits. This outcome was never contemplated and threatens to undermine the effectiveness of the Model Escrow Statutes. Escrow funds so minimized are not adequate to provide security to the States nor do they prevent unfair profit taking.

HOW DOES THE CURRENT ALLOCABLE SHARE RELEASE PROVISION SUBVERT THE PURPOSES OF THE MODEL STATUTE?

Participating Manufacturers under the MSA make payments to the States based on their nationwide sales. The States share in the payments in accordance with fixed percentages, known as Allocable Shares. By contrast, under each State's Model Statute, NPMs make payments only on their cigarettes sold in that State. The payments are designed to be the same as the payments that would be made on an equivalent number of cigarettes under the MSA if the NPM had become a Participating Manufacturer. The loophole that this legislation seeks to close gives some NPMs an immediate release of nearly all of those payments.

By way of example, consider an NPM that makes all its sales -- 100 million cigarettes -- in a state whose allocable share of MSA payments is two percent. Under the current statute, that NPM would be entitled to an immediate release of that portion of its escrow deposit that exceeds what would have been the State's allocable share of the NPM's total MSA payment had it been an MSA participant. Under this example, because the NPM makes all its sales in a single State and because the escrow deposit per cigarette and the MSA payment per cigarette are approximately the same, the NPM's (hypothetical) total MSA payment is the same as its escrow deposit. However, because the State's allocable share of the total MSA payment is only two percent, under current law the NPM would be

entitled to a release of 98 percent of its Escrow deposit. In other words, although the NPM sold 100 million cigarettes in the State, the amount it would have to leave in escrow would be based on only 2 million cigarettes. Accordingly, some NPMs that sell large numbers of cigarettes in a given State are not being required to keep significant funds in escrow in that State despite the volume of cigarette sales that continue to impose substantial health and other costs on that State. This outcome frustrates the fundamental objective of the Model Escrow Statute.

As the example demonstrates, the current provision permits an NPM that has geographically concentrated sales to obtain a refund of the vast majority of its escrow deposits. This allows the NPM to significantly lower the cost of its cigarettes, because the NPM is not escrowing its full share of the future healthcare burden that its product imposes on the State. In lowering the cost, the NPM presents a product that is very attractive to kids, whose cigarette usage is sensitive to price.

HOW DOES THE PROPOSED AMENDMENT REMEDY THE PROBLEM?

The proposed amendment to the Model Escrow Statute eliminates the unintended consequence of the original language that has compromised the law's effectiveness. The amendment is necessary to accomplish the fundamental purpose of the law: to ensure that every NPM is required to post escrows for sales of its cigarettes in the State that provide a meaningful fund from which the State can recover damages in the event it obtains a judgment against the NPM.

This first part of the amendment would limit releases from escrow accounts to any amounts paid into escrow in excess of the MSA payments that the NPM would have been required to make as a PM on account of cigarettes sold in the State for a particular year. Thus, under the amendment the MSA payments relevant to release would not be limited to a State's allocable share of the NPM's (hypothetical) total MSA payments, but rather would be the NPM's MSA payments on the same number of cigarettes as are sold in the State. In other words, under the above example where the NPM sells 100 million cigarettes in a State, the NPM under the amendment would be entitled to a release only to the extent that its escrow payment exceeded what would have been its MSA payment on these 100 million cigarettes.

WEREN'T STATES TOLD THEY WERE NOT SUPPOSED TO AMEND THE MODEL STATUTE?

All States have Model Statutes. Their payments are potentially subject to reduction if Participating Manufacturers establish that the statute has been amended in a way that disqualifies them from being Model Statutes. All the Original Participating Manufacturers and all the major Subsequent Participating Manufacturers have signed letters of assurance declaring that the proposed amendment will not affect the status of the Model Statute. Thus, a State that enacts the amendment will continue to have the protection afforded by having a Model Statute. In fact, the amendment strengthens the Model Escrow Statute by eliminating the unintended consequence that confers an unfair competitive advantage on some NPMs.

The amendment is consistent with the purposes of the Model Escrow Statute: it sharply reduces the ability of an NPM to minimize its payments by concentrating its sales in one or two states and it sharply reduces the unintended disparity created by the current Model Escrow Statute.

WHAT HAPPENS IF THE AMENDMENT IS CHALLENGED AS UNCONSTITUTIONAL?

There is no significant risk of the proposed amendment being held unconstitutional. The Model Escrow Statute, or versions identical to it in other states, has been challenged and consistently been upheld as a valid enactment. For example, in Star Scientific Inc. v. Beales, 278 F.3d 339 (4th Cir.), cert. denied, 123 S.Ct. 93 (2002), the Fourth Circuit Court of Appeals held that Virginia's statute was constitutional under the Equal Protection, Due Process, and Commerce Clauses. In none of the lawsuits has a court suggested that the aspect of the statute that the proposed legislation would amend is necessary to its constitutionality.

Moreover, in the unlikely event the amendment were challenged and struck down as unconstitutional, there exists a "back-up provision" which eliminates the paragraph dealing with the allocable share release in its entirety. Should the Model Escrow Statute thereafter be held unconstitutional due to the ABSENCE of the allocable share release paragraph, then the original Model Escrow Statute language would be restored. As a result, in the extremely unlikely event that BOTH alternative changes (i.e., eliminating the loophole, and eliminating the release paragraph altogether) are held unconstitutional, the Statute would be restored to its original constitutionally upheld position. This "revival" provision is a general rule that exists in every state – namely if an unconstitutional amendment is passed, the law is restored to its prior condition. (Think of it this way: If you amend your assault statute, and the amendment is held to be unconstitutional, assault doesn't suddenly become legal. Rather, the law is restored to its original position, because the unconstitutional change is deemed to be a nullity.)

WILL PASSAGE OF THE AMENDMENT PUT AT RISK MY STATE'S MSA PAYMENTS?

NO. Passing the amendment will NOT jeopardize a State's MSA payments. The only parties that could make such a challenge are parties to the MSA. The parties that make the preponderance of the payments have signed letters of assurance that the amendment will not affect the salutary effect of the Model Escrow Statutes. Companies that want to maintain an unfair competitive advantage may try to scare States with misinformation so that they can continue to profit by exploiting the loophole in the current statute. States that enact the amendment will ensure that NPMs who sell in their States make escrow deposits as originally intended.

HOW WILL THIS AMENDMENT PROTECT PUBLIC HEALTH?

Studies have repeatedly demonstrated that cheap cigarettes are favored by kids, who tend to be more price-sensitive than adults. By ensuring that NPM cigarette prices include some of the cost burden imposed on the State, this amendment will maintain the price of NPM cigarettes at a higher level and help discourage another generation of minors from becoming addicted to cigarettes.

WILL THE PROPOSAL HAVE A FISCAL IMPACT?

The proposed amendment would likely be "revenue neutral." Escrow deposits do not constitute state revenues; they remain the property of the NPM. However, the legislation would likely result in a reduction in the administrative costs of enforcing the Model Escrow Statute because there would be fewer requests for releases from escrow for the State to process. Moreover, should the State obtain a judgment against an NPM to recover the health care costs imposed on the State by the NPM's products, the proposed legislation would enhance the State's ability to recover that judgment.

STATE OF ALASKA

DEPARTMENT OF LAW

OFFICE OF THE ATTORNEY GENERAL

Frank H. Murkowski, Governor

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February 26, 2004

Representative Eric Croft
State Capitol Building
Juneau, Alaska 99801-1182

Re: HB 503
Our File: 023-96-0114

Dear Rep. Croft:

You raised a question in the House Finance hearing of February 25 regarding whether a tax-crediting approach would be a workable solution to the NPM issue. My understanding from the National Association of Attorneys General (NAAG) is that various proposals along these lines have been proposed in other states. For instance, legislation that imposes a fee of \$.50/pack on NPM cigarettes only has been enacted in Michigan and has been introduced in Utah and Indiana. A working group of states and NAAG has determined that this legislation has serious constitutional and antitrust problems, a conclusion with which I am not inclined to disagree.

Another proposal is similar to what you suggested yesterday: an additional tax with a credit for MSA payments. This proposal is apparently currently under consideration in the Missouri. The problem with this particular proposal is that whereas MSA payments are determined on a national basis with each participating state sharing in those payments based on a fixed allocation percentage, a tax credit based on in-state sales would effectively convert MSA revenue calculation and apportionment to a state-by-state sales methodology, which could substantially change the amounts of revenue states receive under the MSA. NAAG is also concerned that enactment of such legislation could result in litigation by the participating manufacturers alleging that the state had breached the MSA. That being said, my current understanding is that NAAG is open to consideration of similar proposals that do not have such problems and that work is ongoing in this regard on a national level. If such a proposal is ultimately recommended to the states for adoption by NAAG, we will certainly bring it to the attention of the legislature.

Representative Eric Croft
Re: HB503
Our File: 023-96-0114

February 26, 2004
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Additionally, I have updated and enclosed the spreadsheet I distributed at the hearing in an effort to better demonstrate the impact of geographic market concentration by an NPM. Hopefully, this updated spreadsheet will more readily reveal the significant windfall available to NPMs when they concentrate their sales in a few states, and how the HB 503 proposal restores the level and fair playing field originally intended by the MSA.

Sincerely,

GREGG D. RENKES
ATTORNEY GENERAL

By:



Michael A. Barnhill
Assistant Attorney General

MAB:mi

Enclosure

cc: David Marquez, Department of Law, Civil Division
Deborah Behr, Department of Law, Civil Division
Johanna Bales, Department of Revenue, Tax Division
Mike Tibbles, Office of the Governor, Legislative Office
Rep. John Harris, Co-chair House Finance Committee
Rep. Bill Williams, Co-chair House Finance Committee
Rep. Kevin Meyer, House Finance Committee
Rep. Mike Chenault, House Finance Committee
Rep. Richard Foster, House Finance Committee
Rep. Mike Hawker, House Finance Committee
Rep. Bill Stoltze, House Finance Committee
Rep. Carl Moses, House Finance Committee
Rep. Hugh Fate, House Finance Committee
Rep. Reggie Joule, House Finance Committee

**NPM Escrow Release Calculations
for hypothetical non participating manufacturer
Cheap Smokes, Inc.**

Cheap Smokes' national cigarette sales	100,000,000				
Approx. MSA Contr./cigarette	\$0.02				
"As if" MSA Contribution	\$2,000,000				

	Alaska	Washington	California	Oregon	Total
MSA Allocable Share Percentage	0.003414187	0.020532582	0.127639554	0.0114766	
Allocable share of Cheap Smokes' "as if" MSA payment	\$6,828.37	\$41,065.16	\$255,279.11	\$22,953.16	\$326,125.81

Cheap Smokes' sales	1,000,000	20,000,000	75,000,000	4,000,000	100,000,000
Approx. Escrow Deposit/cigarette	\$0.02	\$0.02	\$0.02	\$0.02	
Escrow Deposit Requirement	\$20,000	\$400,000	\$1,500,000	\$80,000	\$2,000,000

Current Law:

Escrow Release Threshold	\$6,828.37	\$41,065.16	\$255,279.11	\$22,953.16	\$326,126
Escrow Release Amount	\$13,171.63	\$358,934.84	\$1,244,720.89	\$57,046.84	\$1,673,874
Amount Left in Escrow	\$6,828.37	\$41,065.16	\$255,279.11	\$22,953.16	\$326,126
Effective Amount Deposited/Cigarette	\$0.0068	\$0.0021	\$0.0034	\$0.0057	\$0.0033

HB 503 Proposal, Section 1:

Escrow Release Threshold	\$20,000	\$400,000	\$1,500,000	\$80,000	\$2,000,000
Escrow Release Amount	\$0.00	\$0.00	\$0.00	\$0.00	\$0
Amount Left in Escrow	\$20,000	\$400,000	\$1,500,000	\$80,000	\$2,000,000
Effective Amount Deposited/Cigarette	\$0.02	\$0.02	\$0.02	\$0.02	\$0.02

HB 503 Proposal, Section 2:

Escrow Release Threshold	none
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HB 503 Proposal, Section 3:

same as current law

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**Amendment to the Allocable Share Release Provision of State Escrow Statutes
Status of State Legislation**

(Please Note: This chart is based on the most current information available to the NAAG Tobacco Project as of April 16, 2004. The actual status of these and other similar bills may not be properly reflected here. Please check with individual states for current status.)

	STATE	BILL STATUS
1	Alabama	Signed into Law
2	California	Signed into Law
3	Colorado	Passed by the Legislature
4	Georgia	Passed by the Legislature
5	Hawaii	Signed into Law
6	Idaho	Signed into Law
7	Illinois	Signed into Law
8	Indiana	Signed into Law
9	Iowa	Signed into Law
10	Kentucky	Passed by the Legislature
11	Louisiana	Signed into Law
12	Maine	Signed into Law
13	Maryland	Passed by the Legislature
14	Michigan	Signed into Law
15	Montana	Signed into Law
16	Nebraska	Passed by the Legislature
17	New Mexico	Signed into Law
18	New York	Signed into Law
19	Ohio	Signed into Law
20	Oklahoma	Signed into Law
21	Oregon	Signed into Law

22	South Dakota	Signed into Law
23	Tennessee	Passed by the Legislature
24	Utah	Signed into Law
25	Vermont	Signed into Law
26	Washington	Signed into Law
27	West Virginia	Signed into Law
28	Wisconsin	Signed into Law
29	Wyoming	Signed into Law